MOODY'S
INVESTORS SERVICE

Rating Update: Moody's downgrades Kansas issuer rating to Aa2 from Aa1, notched ratings to Aa3 from Aa2 and KDOT highway revenue bonds to Aa2 from Aa1; outlook stable

Global Credit Research - 30 Apr 2014

Downgrade affects over $2.8 billion of outstanding bonds

KANSAS (STATE OF)
State Governments (including Puerto Rico and US Territories)
KS

Opinion

NEW YORK, April 30, 2014 --Moody's Investors Service has downgraded the state's issuer rating to Aa2 from Aa1 and notched ratings to Aa3 from Aa2 on the state's $1.23 billion of outstanding subject-to-appropriation bonds, and $1.6 billion of state highway revenue bonds from Aa1 to Aa2.

SUMMARY RATING RATIONALE

The downgrade reflects Kansas' relatively sluggish recovery compared with its peers, the use of non-recurring measures to balance the budget, revenue reductions (resulting from tax cuts) which have not been fully offset by recurring spending cuts, and an underfunded retirement system for which the state is not making actually required contributions. In recent years the state has appropriated funds from or shifted costs to the State Highway Fund to help balance the general fund budget. The phasing in of increasing income tax cuts, along with rising pension costs, will continue to exert pressure on the budget.

Kansas' Aa2 rating is supported by the state's diverse economy underpinned by the aerospace industry, moderate debt levels, low unemployment levels and history of strong governance.

The downgrade of the state highway revenue bonds is based on our view that the Kansas Department of Transportation (KDOT) revenues are insufficiently insulated from state general operating needs for KDOT's debt to achieve a rating higher than the state's issuer rating. Use of SHF funds for general operating purposes can limit KDOT's flexibility and add to pressure from sources such as highway revenue shortfalls or liquidity needs related to KDOT's outstanding variable-rate debt portfolio, which is among the largest of state highway bond issuers.

Strengths:

- Historically strong governance, with adherence to fiscal best practices

- Low unemployment rate and other favorable economic indicators

- Return to positive GAAP-basis fund balance and improved liquidity

Challenges:

- Likely reduction in ending fund balance as enacted income tax cuts take effect

- Use of non-recurring measures to achieve operating budget balance

- Weak pension funded status and growing pension costs

DETAILED CREDIT DISCUSSION

KANSAS' ECONOMIC RECOVERY HAS LAGGED THE NATION'S

Kansas' economic recovery has been slower than many of its peers, with an economy that is only expected to enter expansion mode in 2015. Moody's Analytics estimates that the state has regained about three-quarters of jobs lost to the recession. Unemployment is relatively low at 4.9% versus the national average of 6.7% as of

February, 2014, but employment growth has been sluggish. Both are due in part to the state's slow population growth. Aviation manufacturing continues to be a key sector in the state and its recent comeback, partially due to backlog built up during the recession, has aided the state's payroll recovery. While the sector accounts for a small portion of total non-farm employment, it has heightened economic significance given its high wages and impact on other industries. The outlook for the sector is cautious as reduced global demand and cost control remain challenges. Flat population growth, tempered government spending in health care and manufacturing uncertainty will likely mean underperformance in employment and income growth compared to the nation in the long run.

STATE'S INCOME TAX LEGISLATION CALLS FOR SUCCESSIVE REDUCTIONS IN COMING YEARS

Significant income tax cuts were enacted in fiscal 2012 and 2013. The top rate (on incomes greater than or equal to $15,000 for single filers) was lowered to 4.8% from 4.9% and the bottom rate (on incomes below $15,000) was cut to 2.7% from 3%. The 2012 tax cuts eliminated the top rates of 6.25% and 6.45% and consolidated rates at 3% and 4.9. Tax measures passed in 2013 ratchet tax rates lower every year through fiscal 2018.

Depletion of financial reserves will likely result from the tax cuts in future years, without offsetting actions. Since the state has no official rainy day fund, general fund ending balances act as a cushion again financial stress and are statutorily required to be 7.5% of total expenditures and demand transfers (the so-called spending lid). Similar to many states that drew down reserves during the economic downturn, Kansas' ending balances were below the ending balance requirement in fiscal 2009, 2010 and 2011. The state managed to build the balance again in fiscal 2012 and 2013, though it utilized other non-recurring revenue sources in those years. Fiscal 2014's ending balance is projected at 8.8%, but only 4% for fiscal 2015 and could decline further as the impact of the tax cuts deepens.

Reduction in year-end balances is a significant credit weakness compared with similarly rated entities who have begun to rebuild rainy day funds again. In recent years, the state also reported several years of negative GAAP-basis, year-end, fund balances before returning to a positive position in fiscal 2012 and 2013. Inability to maintain a positive, audited general fund balance position would indicate that the state is also no longer adhering to its traditionally conservative financial management practices.

INCOME TAX ELIMINATION PLAN ENTAILS RISKS

Some states, such as Alaska (Aaa, stable), Florida (Aa1, stable), and Texas (Aaa, stable) impose no personal income tax of any kind. The median share of tax revenues derived from income taxes among all 50 states is 38%, including states that have no income tax, according to the National Association of State Budget Officers. In view of the high ratings assigned to many states without income taxes, we do not view the lack of a state income tax, in and of itself, as a credit weakness. However, eliminating a tax that has been in place for many years and has accounted for a large share of revenue entails risks. In Kansas' case, income and inheritance taxes have accounted for about half of general fund revenues. As the state income tax is removed, Kansas' revenue structure will become more dependent on excise and severance taxes and the full economic impact is unclear. The state's ability to maintain structural balance long-term may also depend to an increasing degree on its capacity for spending cuts. The state's ability to impose budget cuts over time may be limited in several areas: by court mandates (in K-12 funding), by federal program mandates (in Medicaid) and by state legal requirements (pension funding). These constraints could also lead the state to credit-negative actions such as suspension of the spending lid or appropriation from other one-time sources such as the state highway fund.

Despite the implicit risks of a plan to eliminate a key revenue source, Kansas has taken some steps to offset the near-term effect of the tax-cuts. Offsetting revenue increases include reducing the state's sales tax rate to 6.15%, rather than letting it fall to 5.3% as previously planned. The state also imposed limits on itemized, non-charitable deductions and reduced the standard deduction. The net impact of these measures reduced some of the impact on ending balances or budgetary stress would have been significantly worse. In addition, the ultimate elimination of the individual income tax under present law will be contingent on meeting certain revenue performance targets. Rate cuts in tax year 2019 and beyond require that current-year general fund revenues be at least 2% greater than the prior year's.

FISCAL 2014 PLAN DRAWS ON STATE HIGHWAY FUND FOR GENERAL PURPOSES

Kansas has used its highway fund sporadically to offset weakness in general fund tax revenues. In fiscal 2012, the state supplemented general fund revenues with a $205 million transfer from the highway fund, asserting that lowered inflation estimates allowed this transfer to occur without reducing highway project funding. In fiscal 2013, the state did not use the highway fund for general fund purposes. The fiscal 2014 budget, however, includes a $140 million cost shift to the highway fund from the general fund, to cover school transportation expenses, and it also calls for a $15 million transfer to the general fund from the highway fund. In fiscal 2015, the budget calls for a $107 million cost shift and another $15 million transfer.

PENSION FUNDING REMAINS A CHALLENGE, BUT STATE CONTINUES REFORM EFFORTS

Pension under-funding remains a significant challenge for the state. The Kansas Public Employees Retirement System (KPERS) reported an $7.7 billion 2012 unfunded actuarial accrued pension liability and the funded ratio (assets as a share of total liabilities) was just 56%. Based on Moody's adjustments to the reported numbers, the KPERS adjusted net pension liability (ANPL) was $16.7 billion. Our adjustments apply a common, market-based discount rate, as well as a 20-year amortization, and assume that the liabilities have a 17-year duration, in order to improve comparability with other states. One factor in the growth of unfunded KPERS liabilities has been a statutory pension funding regime in which employer contributions are less than the actuarial annual required contribution (ARC). Pension reforms now require the state to ramp up their annual contributions to meet the ARC. The state is expected to reach full funding of the ARC in 2019 by increasing the current level of contributions from $402 million in fiscal 2014 to $601 million in fiscal 2019. This schedule could vary depending on asset returns.

We believe the state will continue efforts to enact reforms that make these liabilities more manageable over time. In 2012, Kansas passed legislation creating a cash-balance plan that will take effect for new employees as of January 2015. This will reduce the state's exposure to investment underperformance. The Securities and Exchange Commission since late 2010 has been conducting a confidential inquiry into the state's past pension liability disclosure practices, and the state, KDFA and KPERS are cooperating.

DEBT BURDEN RELATIVE TO OTHER STATES HAS DECREASED IN RECENT YEARS

Relative debt burden has decreased, following years in which Kansas' net tax supported debt ranking was boosted by the Kansas Department of Transportation's (KDOT) borrowing for state highway projects. KDOT obligations are backed by gasoline taxes and other revenues of the state highway fund, not by state general fund revenues. Kansas' 2013 net tax-supported debt burden ranked 27th among states, at 2.8% of personal income, equal to the 50-state median. It ranked 24th based on population, at $1,112 per capita, compared with US median of $1,074. These rankings were significantly lower than eight years earlier, when the state ranked 16th for debt to income and 14th for debt per capita. The state's debt service ratio (total 2012 debt service payments as a share of operating and other pledged revenues) is also moderate, at 4.5%, compared with a 4.9% US median. KDOT's obligations also include one of the largest swap and variable-rate debt portfolios in proportion to total debt among highway revenue bond issuers. While KDOT has greatly lowered variable-rate debt exposure over the past few years, variable rate obligations still comprise approximately 31% of their total outstanding debt. Total swap exposure ($510 million notional) is intended to hedge against rising interest costs on variable-rate debt and is also high at 31% of debt outstanding

OUTLOOK

The outlook for all the debt is stable. The Aa2 rating incorporates implementation risks from the state's plans to eliminate its income taxes, significant unfunded pension liabilities that are likely to grow and put further presser on the state's budget, inconsistent ending balances which are meant to act as a reserve buffer in downside financial scenarios, and an economy that is likely to underperform the nation due to sluggishness in key manufacturing sectors.

WHAT COULD MAKE THE RATING GO UP

-- Established trend of structurally balanced operations

-- Rebuilding and maintenance of ending balances

-- Significant improvement in funding of pensions

WHAT COULD MAKE THE RATING GO DOWN

-- Worsening structural imbalance and negative fund balances

-- Aggressive growth assumptions based on elimination of income tax

-- Suspension of spending lid law

-- Use of non-recurring budgetary measures or payment delays

-- Growth in unfunded pension liabilities

The principal methodology used in this rating was US States Rating Methodology published in April 2013. The additional methodology used in rating the appropriation bonds was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. The additional methodology used in rating the Kansas Department of Transportation Highway Revenue Bonds was US Public Finance Special Tax Methodology published in January 2014. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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